ASSET PROTECTION AND YOUR REVOCABLE TRUST

By: James W. Mallonee
April, 2015

Lawyers are frequently asked if a client's non-exempt assets are protected from creditors when placed into an individual's revocable trust. Sadly, the answer is no. The only means by which a person could have their non-exempt assets protected from creditors when placed into an individual revocable trust is to have a spendthrift clause coupled with a Qualified Terminable Interest Property trust ("QTIP"). QTIP trusts are usually created for the benefit of a spouse.

When property is titled jointly between spouses, it is presumed to be titled as Tenants by the Entireties ("TBE"). Under Florida law, if one spouse has a judgment or debt charged against them individually, the TBE property is protected from the creditor claim because it is considered a single unit of both spouses. As a result, a husband and wife's joint assets are protected from being claimed by a creditor (except for defaults on a mortgage, claims of lien, and taxes on a particular piece of property).

As a family's assets approach or exceed the Federal Government's estate tax threshold, spouses will often split their non-exempt TBE assets into two equal portions. Once split, each spouse takes one of the split portions and places it into their individual revocable trust. When assets are split out individually to fund one spouse's revocable trust, they become vulnerable to that spouse's creditor claims.

Florida's legislature has passed a law that creates a mechanism by which a trust can be created to get both the protection from creditors and reduce estate tax exposure. The statute is Section 736.0505, Fla. Stat. The new statute treats a deceased spouse's QTIP trust as having its funding come from the deceased spouse, even if the funds were contributed by the surviving spouse. This is also true if the QTIP trust reverts back to the surviving spouse as a separate trust.

Its sounds complicated but the means by which a QTIP trust can be constructed is fairly simple. The basics are these, a husband funds a QTIP trust for his wife. The wife will have access to the trust income and principal during her lifetime. In the event the wife dies before the husband, the wife's QTIP trust contains a provision that passes her QTIP funds to a Residuary Trust for the husband. Both the QTIP and Residuary Trust utilize a spendthrift clause which has the power to protect the principal from creditors. In essence, a creditor cannot levy the non-exempt property until the beneficiary takes possession of the income or principal from either the QTIP or Residuary Trust.

When a couple elects to consider a QTIP trust, the assets placed into it usually equal the amount of the current applicable exclusion for Federal Estate Tax with the balance passing to the surviving spouse. The result being that the deceased spouse's estate passes tax free to the surviving spouse and maintains protection from creditors.

Although a QTIP trust may sound simple, there are some issues that you must be aware of prior to running out to your attorney of choice to have one prepared.

Recent research by Barry A. Nelson and Richard R. Gans suggests that to take advantage of the creditor protection, it must appear as if the preparation of the husband and wife's QTIP trusts were done independent of each other. This suggests that a husband and wife QTIP trust cannot look and feel the same. Some ideas on making a separate Husband and Wife QTIP trust appear dissimilar are different trustees, different compensation, different powers of appointment, different residual beneficiaries or even having each trust prepared on different dates.

The other issue to consider is the beneficiary of the QTIP trust. Once this trust is funded, it becomes irrevocable. Thus, if the bonds of marriage breakdown and a divorce occurs the funds will lose its entitlement as a marital deduction and will revert back to the original spouse creating a possible loss of creditor protection and worse, an estate or gift tax problem.

In addition, a QTIP trust may not be ideal for you if a spouse has an outstanding debt or judgment against them because such debt or judgment will take priority if you make an attempt to fund the judgment spouse's trust. As a result, if you elect to go forward with a QTIP trust, consider satisfying any and all debts or judgments prior to funding separate Husband and Wife QTIP trusts.

Lastly, be aware that there are certain creditors that can circumvent a spendthrift clause such as IRS levy's, child support and alimony payments.

In any event, the message is that Florida's legislature has created tools to create a trust to protect your non-exempt assets from creditors while at the same time giving pause to managing your assets in an effort to avoid Federal Estate Tax. If you believe that your estate exceeds the present $5 million individual ($10 million for married couples) estate tax exclusion, it may be worth while to talk to your attorney to get a feel of whether a QTIP trust is best for you and your spouse. It could save you substantial dollars in Federal estate tax dollars and protect your non-exempt assets from creditors.